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Honorable Mayor and City Council  
City of El Segundo, California

In planning and performing our audit of the financial statements of the City of El Segundo (City) as of and for the year ended September 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the City's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the City's financial statements that is more than inconsequential will not be prevented or detected by the City's internal control. Matters conforming to this definition are identified below.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the City's internal control. Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any material weaknesses.

**(1) Need to Establish a Formal Ethics Policy and Fraud Policy**

We noted that the City already has in place a number of practices to communicate its expectation of ethical behavior to all employees through verbal communications, trainings and by setting proper tone at the top. However, we noted that the City does not have a formalized ethics policy. A well structured ethics policy establishes organizational standards for ethics, morals and an overall "regard for the rules" philosophical approach within the City. Specifically, matters such as honesty, integrity, compliance with laws and regulations, adherence to corporate policy and upholding the City's high values and reputation are addressed. A strong ethics policy is the foundation upon which the City builds its culture, which should then permeate all levels of personnel and guide all business dealings and transactions. This can be most

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effective in establishing a highly ethical and antifraud culture within any business organization.

We also noted that the City's practices do not include a clearly communicated process for employees to report suspected fraud or other unethical conduct. A written fraud policy can be an effective method of communicating and reinforcing an antifraud culture within a City. A fraud policy communicates the City's position and policy on matters to all employees such as the following:

- Risks that the City faces from fraud, abuse and other forms of misconduct;
- Definitions of ethical misconduct, including failure to follow City policies and procedures, misrepresentation of financial data, and theft, misuse, or misappropriation of City assets;
- Employee's responsibility to report witnessed ethical misconduct (including an established reporting mechanism, such as reporting to an independent party such as Human Resources, a member of the Board of Directors, a designated member of the City's management, hotline service, etc.);
- Organizational responsibility to investigate; and
- Disciplinary action for violations

Best practice suggests that an ethics policy and fraud policy and their annual reaffirmation by employees will greatly strengthen internal controls to prevent the occurrence of fraud and abuse. The policies should be acknowledged and signed by each employee upon hire and on an annual basis as evidence of their affirmation that they understand the policy and have complied with its provisions.

As of the date of this letter, the City's policy was drafted and pending approval by the City Council.

### **Recommendation**

We recommend that the City establish and implement an ethics policy and a fraud policy. Once developed, the policies should be acknowledged and signed by each employee at time of hire and on an annual basis thereafter as evidence of their affirmation that they understand the policy and will/have complied with its provisions. We also suggest that the City implement an effective reporting mechanism for fraud and other unethical conduct. Internal reporting channels, such as managers' open-door policy, hotlines for anonymous tips or a clearly defined reporting protocol (what to report, who to report to, etc.), have been found to be effective. This is a repeat recommendation from the prior year audit.

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### **Management's Response**

The City is in the process formalizing an ethics and a fraud policy. Drafts of the policies have been written and are currently being reviewed by the City's attorney. Once they have been finalized, the policies will be presented to Council for approval.

### **(2) Golf Course Cash Disbursements**

During our review and testing of internal controls over cash disbursements at the golf course, we noted the following:

- The Golf Course Accountant who processes accounts payable and prints the checks also receives the signed checks and mails them out.
- Although the Golf Course Accountant does give the check signers all supporting documentation with each check. However, the check signers do not receive the final check register for review to ensure all checks are being accounted for.

### **Recommendations**

We recommend the following:

- The signed checks should not be returned to the Golf Course Accountant. Instead, someone independent of the accounts payable function (i.e. a receptionist or other staff member) should be responsible for stuffing, sealing, and mailing the checks.
- The check signers should be provided with the final check register along with the prior check register to ensure there are no gaps in check numbers and all checks are being reviewed and accounted for.
- The General Manager should receive the unopened bank statements to review the debits to the account as well as the fronts and backs of canceled checks to ensure payments were issued to authorized vendors.

These are repeat recommendations from the prior year audit.

### **Management's Response**

The City and the management company have acknowledged the recommendations of MHM and have made changes to strengthen the internal controls of the Golf Course's cash disbursements process. The final check register for the current check run and the prior check register are provided to the check signers to ensure all issued checks are

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present and reviewed. After the checks have been signed by the required two authorized signers, a designated pro shop attendant, who is independent of the accounts payable function, compares the checks to the supporting documentation to verify correctness of amount, payee and invoice number. The pro shop attendant stuffs, seals and mails the checks that are less than \$5,000 and/or are not payable to the management company. Checks greater than \$5,000 and/or payable to the management company are forwarded to the City's Finance Director for approval and the City Manager's signature. A designated person in the City's Treasury Department reviews the checks and supporting documentation for accuracy and proper signatures. Next, the Treasury Department personnel stuffs, seals and mails the checks.

Bank statements are mailed directly to the City's Treasury department, not the Golf Course. Each month, the Golf Course's accountant downloads a copy of the bank statement and prepares the bank reconciliation. A copy of the reconciliation and the bank statement is sent to the City Senior Accountant for review as a part of the month-end closing procedures.

### (3) **Investment Compliance**

Section 53601(k) of the *California Government Code* states the following:

"Medium term notes may not exceed 30 percent of the agency's money that may be invested. Notes eligible for investment under this subdivision shall be rated 'A' or better by a nationally recognized rating service."

As of September 30, 2009, medium-term notes represented 31.30% of the City's total investment portfolio. In addition, the ratings of three of the medium term notes were A3, BAA3, and WR as of year end. This condition occurred because the City Treasurer's office evaluates investment compliance at the time of purchase only.

### **Recommendation**

We recommend the City Treasurer's Report include a statement to disclose any noncompliance issues as of the date of the City Treasurer's Report.

### **Management's Response**

The Treasurer's office is aware that under the State Law we were out of compliance for our corporate holdings. With the fall of Lehman and the trouble with AIG, bonds that we bought were in compliance with our investment policy at the time of purchase. It is the Treasury Department understanding that the 30 % rule applies at the time of investment, when we were in compliance. There is nothing our investment policy that requires the City to sell bonds at a loss to reach compliance.



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The City's written responses to the significant deficiencies identified in our audit are described above. We did not audit the City's responses, and accordingly, we express no opinion on them.

This communication is intended solely for the information and use of the City Council, City's management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

*Mayor Keith McLean P.C.*

Irvine, California  
April 26, 2010